

ORIGINAL
FILE

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

NOV 13 1992

In the Matter of

Open Network Architecture Tariffs
of Bell Operating Companies

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

CC Docket No. 92-91

REPLY COMMENTS OF THE
AMERITECH OPERATING COMPANIES

In an Order released April 16, 1992, in the above-captioned docket,¹ the Common Carrier Bureau (Bureau) combined the investigations relating to Open Network Architecture (ONA) service rates instituted in several prior Orders² and designated specific issues to be examined. In their Direct Case, the Ameritech Operating Companies³ responded to the questions posed by the Bureau.⁴ In these reply comments the Companies respond to issues raised in the comments to the Companies' Direct Case.

¹ See, Order Designating Issues for Investigation, DA 92-483 (Designation Order).

² See, Ameritech Operating Companies, Revisions to Tariff F.C.C. No. 2, Open Network Architecture, Memorandum Opinion and Order, 7 F.C.C. Rcd 257 (Com. Car. Bur. 1991), modified by Ameritech Operating Companies, 7 F.C.C. Rcd 948 (Com. Car. Bur. 1992); Bell Atlantic Telephone Companies, et al., Open Network Architecture Tariffs, 7 F.C.C. Rcd 1512 (Com. Car. Bur. 1992) (ONA Investigation Order); Ameritech Operating Companies, et al., Open Network Architecture Tariffs, DA 92-273 (Com. Car. Bur., released March 6, 1992) (BSE Withdrawal Tariff Order).

³ The Ameritech Operating Companies are: Illinois Bell Telephone Company; Indiana Bell Telephone Company, Inc.; Michigan Bell Telephone Company; The Ohio Bell Telephone Company; and Wisconsin Bell, Inc. These entities are occasionally referred to as "the Companies" or the "AOCs" in these reply comments.

⁴ Direct Case of the Ameritech Operating Companies, dated May 18, 1992.

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I. GENERAL MATTERS

A. Flexible Cost-Based Pricing

Several parties expressed concern about the wide disparity among the Regional Bell Operating Companies in the BSE rates. Disparity of prices is to be expected as each companies' cost structure is different. In adopting a flexible pricing standard for BSEs, the Commission recognized the need to provide LECs the ability to price efficiently and the incentive to innovate.⁵ The flexible cost-based approach adopted by the Commission facilitates achievement of these goals without compromising other regulatory concerns. A flexible cost-based approach encourages LECs to innovate because the return on investment is commensurate with the risk they assume.⁶

The Companies have followed precisely the pricing guidelines established by the Commission. The direct costs have been correctly identified and reasonable overhead loadings have been applied. A consistent cost methodology was used for each BSE. Moreover, appropriate cost support has been furnished to explain the costing principles used. There is absolutely no basis to conclude that any aspect of the AOC costing methodology is incorrect. Thus, there is no basis to conclude that the BSE rates are unreasonable. The Companies' BSE rates comply with the spirit and goals of ONA.

Any attempt to revise the flexible cost-based pricing standard would perpetuate the pricing inefficiencies the Commission is attempting to eliminate. The LECs must have the ability to price in a manner that will encourage the development of an advanced telecommunications network. A return to rigid

⁵ See, Part 64/ONA Order at paras. 38-47.

⁶ Id.

pricing standards will frustrate attempts to mold this industry into a fully competitive one.

The initial ONA tariff filings are an essential first step on the road to fully implementing ONA. The BSE costing methodology of the Companies has been conducted to ensure that the BSE prices comply with all FCC rules and regulations and are reasonable.

The Companies urge the Commission to retain the flexible cost-based pricing methodology to ensure the continued regulatory viability of ONA and to resist adopting more stringent standards as proposed by some parties.⁷

B. Cost Support

Several parties have questioned the use of the Bellcore Switching Cost Information System ("SCIS") model to develop costs for BSE features. The objecting parties decry the inability to have full access to the SCIS model. Their concern is unwarranted. The SCIS model itself, as well as its application to specific aspects of costing, have been thoroughly reviewed by the Commission. Further, the objecting parties have had more than ample opportunity to examine the model and comment on any shortcomings. The use of the SCIS model as a costing tool is effective and proven.⁸

As fully explained in Attachment B, Explanation of the Redaction Process, the SCIS model contains vendor proprietary data that may not be disclosed. The AOCs are only one of many joint owners of SCIS, and therefore, may not unilaterally disclose all the information requested by other parties. Disclosure of additional information would jeopardize the viability of the model.

⁷ See, e.g., Ad Hoc at 10-11.

⁸ For example, the SCIS model has been used in rate-making proceedings in the Ameritech region for several years.

C. Arthur Andersen

Several parties have, without reasonable justification, unfairly attacked the Arthur Andersen study. The study was done in full compliance with FCC requirements (see Attachment A attached hereto). Moreover, the FCC reviewed the Arthur Andersen Work Papers describing the scope of the study. Consequently, the FCC was aware of the scope, objectives and methodology of the study. The study was performed in a highly competent manner and by a well-respected firm. Concerns about their objectivity are baseless.

II. QUESTIONS AND RESPONSES.

The AOC responses to concerns raised with respect to specific questions are as follows:

Question No. 1: Is the development of unit investment for BSEs on the basis of the (short run) marginal investment option of SCIS and SCM a reasonable method that is consistent with the Commission's ONA requirements and policies?

Response:

The basic issue raised by this question is whether the SCIS Model Office should be run using the "marginal" or "average" option in costing the BSEs. There is no consensus among the parties raising this issue. MCI, for example, endorses use of average costs,⁹ whereas others argue that marginal costing is appropriate.¹⁰ It is clear that some petitioner's advocacy of the marginal approach has little to do with economics, but is driven solely by their desire for the lowest possible ONA rates.¹¹ In any event, the lack of consensus

⁹ MCI Opposition at 13.

¹⁰ Allnet Opposition at 6; Wiltel Opposition at 5.

¹¹ Metromedia Comments at 7; Wiltel Opposition at 8.

demonstrates that a “hard and fast” rule would be inappropriate. As long as there is a reasonable basis for the choice made, this flexibility should be retained.

In the case of the BSEs, the objective was to develop a method for unbundling the Local Switching revenue requirement. The AOCs’ ONA plan went further by stating it would accomplish this using fully distributed costing principles. The selection of the average option within SCIS is appropriate for this purpose. It is true that use of average costing in SCIS results in the assignment of “getting started costs” or unused processor capacity to each BSE. This is not inappropriate given the pricing objective. This spare capacity is nothing more than an “overhead” that needs to be allocated consistently to each BSE in much the same manner as common overheads. The AOCs endorse marginal costing principles as appropriate for determining a price floor. However, in the case of the BSEs, a floor is not appropriate, nor is it consistent with fully distributed cost principles.

Metromedia and Wiltel are correct in their assertion that use of the average method produces a higher cost, and therefore price, for ANI.¹² Both are obvious in their attempt to manipulate cost assumption decisions to achieve a particular answer; namely, a lower price for ANI. Use of the average investment option is a reasonable method that is consistent with the Commission’s ONA requirements and policies.

Question No. 2: Have carriers selected model offices that are representative of offices that will be used to provide BSEs?

¹² Id.

Response:

Some petitioners also raise questions about the validity of the model office data.¹³ Metromedia goes so far as to suggest that the model office data could have been strategically manipulated to produce a desired result.¹⁴ Nothing could be further from the truth. As stated in its Direct Case, the AOCs' database contains the entire universe of 5ESS, DMS100 and 100/200, and 1AESS host and remote switching offices in place in the Ameritech region at the time the cost studies were developed.¹⁵ None of the parties challenged the data contained in Attachment 1 to the AOC Direct Case that contains the assumptions relating to switch replacement dates and switch capacities. If the parties cannot identify in what respect the assumptions are incorrect, then their objections to the model offices selected is specious. Further, the AOCs did not change any of the data within its model office specifically for ONA. The study conducted by the AOCs for ONA used the same model office input data that was used to support the multitude of exchange filings in the Ameritech region from mid-1989 to mid-1990.

Some petitioners also stated that the AOCs' input into the SCIS model office were outdated, thus distorting the results.¹⁶ The AOCs update the SCIS model office annually, and the most current data available was used for the BSE cost studies which were conducted in early 1990 and filed in December 1990.

¹³ Wiltel Opposition at 16, MCI Comments at 17 and Metromedia Comments at 11.

¹⁴ Metromedia Comments at 11

¹⁵ Ameritech Direct Case at 2.

¹⁶ Allnet Comments at 7 and Wiltel Opposition at 3.

Question No. 3: Is the use of a cost of money that exceeds 11.25 percent reasonable?

Response:

Some parties assert that a cost of money that exceeds 11.25 percent is unreasonable.¹⁷ None of the parties, however, have disputed the AOCs analysis that demonstrated that the use of a cost of money factor higher than the authorized rate of return does not produce excessive BSE rates.¹⁸ The authorized rate of return calculation used by the Commission to determine over or under earnings is not related to the cost of money used in SCIS. Since SCIS develops forward looking investments, it is appropriate to use the projected cost the AOCs expect to incur in the financial markets in order to acquire and place new investments. Further, as appropriately noted by the GSA, the “cost of money used in their [BOC] models had little effect on their final, loaded cost.”¹⁹ Therefore, whether loadings are developed using the AOCs’ cost of money rather than the 11.25% rate of return is immaterial. The resulting cost, and, in this case, price would have been the same.

Question No. 4: Should 1 ESS and/or 1AESS switch costs be included in the development of BSE rates?

Response:

Several petitioners assert that the inclusion of analog technology is inconsistent with marginal cost principles.²⁰ The AOCs recognize that, in general, digital switches are replacing 1E/1AESS technology throughout its region. However, it

¹⁷ Metromedia Comments at 15, Ad Hoc Comments at Appendix I, pg 9, and Sprint Comments at 9.

¹⁸ Ameritech’s Direct Case at 4, Attachment 1.

¹⁹ GSA at 5.

²⁰ See, e.g. Wiltel Opposition at 10-13.

is incorrect, even under a marginal cost approach, to assume from this single fact that there are no forward-looking incremental costs associated with analog switches.²¹

Marginal cost theory aside, the AOCs committed to price BSEs in accordance with fully distributed costing principles, making the inclusion of analog technology in the direct cost study appropriate. The AOCs did not set out, nor felt it was appropriate, to develop long-run marginal costs for BSEs. As stated in the Direct Case, the AOCs developed the BSE costs in a manner that would consistently allocate the Local Switching revenue requirement to the BSEs.²² Neither use of average costing in SCIS, nor inclusion of analog technology, increases the cost assigned to Local Switching through Parts 36 and 69.

Question No. 5: Are the BellSouth and US West overhead loadings excessive?

Response:

This is not applicable.

Question No. 6 & No. 7: Have the carriers adequately justified their use of nonuniform overhead loadings in pricing BSEs?

Are differences between BSE rates and unit cost differences justified?

²¹ Ad Hoc makes this point by correctly stating, "If, in this case, 1ESS and 1AESS would be used over a reasonable planning period to provide a BOCs proffered ONA BSEs, these costs should be reflected in the economic costs of the service." Ad Hoc Comments at Appendix I, p. 10.

²² Ameritech Direct Case at 6.

Response:

The AOCs did not use nonuniform overhead loadings and have justified the difference between BSE rates and unit costs in its Direct Case.²³

CONCLUSION

The Ameritech Operating Companies submit that the foregoing material is responsive to the questions raised in the comments and oppositions to the Companies' Direct Case and demonstrate that the BSEs have proper cost support. The Companies' rates and tariffs should be permitted to remain in effect as filed.

Respectfully submitted,

By: Pamela J. Andrews
Floyd S. Keene *fsk*
Pamela J. Andrews
Attorneys for the Ameritech
Operating Companies
Room 4H74
2000 West Ameritech Center Drive
Hoffman Estates, IL 60196
(708) 248-6082

Date: November 13, 1992

²³ Ameritech Direct Case at 8.

ARTHUR
ANDERSEN

ARTHUR ANDERSEN & CO. SC

November 10, 1992

Mr. James F. Britt
Executive Director
Bellcore
LCC 2E-243
290 West Mt. Pleasant Avenue
Livingston, New Jersey 07039

Arthur Andersen & Co.

101 Eisenhower Parkway
Roseland NJ 07068-1099
201 403 6100

Dear Mr. Britt:

At your request, this letter provides our views on several issues raised in the comments filed by various parties on the Direct Cases in CC Docket No. 92-91. As you know, some of the comments, or portions thereof, were filed under protective cover and we were therefore unable to review them. However, we will discuss two areas of concern related to our Independent Review of SCIS/SCM that were raised in the public comments filed by one or more of the parties. Those areas are the:

- o Independence and objectivity of Arthur Andersen & Co.
- o Scope of the Independent Review of SCIS/SCM

Independence and Objectivity of Arthur Andersen & Co.

ALLNET alleges at page 2 of its comments that Arthur Andersen "had no incentive to be objective" concerning our independent review of SCIS/SCM. ALLNET alone asserts that because Arthur Andersen provides consulting services to the BOCs, we failed to be objective and critical of the BOCs' cost methodologies and application of SCIS and SCM for fear of losing them as clients.

Such a charge is absolutely false and patently offensive. Arthur Andersen, in all our work, rigorously follows the high professional standards for independence and objectivity set by the American Institute of Certified Public Accountants. Those standards, in no way, restrict us from performing consulting services for clients in order to maintain our objectivity. To the contrary, had we not gained prior experience in the complex costing subjects covered by our review, we may not have met other AICPA standards for technical competence.

Arthur Andersen takes its hard-earned reputation for objectivity and integrity very seriously. For ALLNET to suggest, without offering any specific evidence, that we would compromise our standards is irresponsible.

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Mr. James F. Britt

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Scope of the Independent Review of SCIS/SCM

A number of parties commented on the scope of the Independent Review of SCIS/SCM performed by Arthur Andersen. Several parties observed that our review was not an "audit" of SCIS/SCM or the ONA cost support material filed by the BOCs. Some parties suggest that an audit should have been performed. Other comments call for additional procedures that were not part of the scope of the Independent Review.

In order to render an audit opinion under AICPA professional standards, it is necessary for the auditor to be able to evaluate a financial statement or other presentation for conformity with generally accepted accounting principles or some other comprehensive basis of accounting. Likewise, an independent public accountant can only attest to an assertion made by management when that assertion can be evaluated against reasonable criteria and is capable of reasonably consistent estimation or measurement.

What this means in the context of the BOCs' ONA cost support is that in order for an independent auditor to express an opinion, it would have been necessary for the FCC to issue reasonably explicit guidance on how the cost support was to be developed and applied by the BOCs. Even if it had been the FCC's intent that an "audit" be performed, it would have been difficult given the flexibility allowed by the FCC for developing ONA tariff cost support.

Section 3.0 of our report clearly sets forth the background for the purpose and scope of our Independent Review of SCIS/SCM. In fact, our review was not an "audit" as that term is used by the accounting profession. The SCIS Disclosure Order itself is perhaps a source for some of the confusion in that the FCC referred to the procedures to be performed by an independent auditor as an "audit". However, the FCC Staff was kept well-informed of the details of the scope of our review at all times through the required filing of a draft work plan and several meetings at which comments and input were solicited. During these meetings, the Staff informally indicated that the scope of our Independent Review was entirely consistent with the requirements of the SCIS Disclosure Order.

If we can provide any additional information, or answer any questions you may have, please do not hesitate to call Mr. Joseph P. Perrone at (201) 403-6250 or Mr. James E. Farmer at (312) 507-6641.

Very truly yours,



ARTHUR ANDERSEN & CO.

Explanation of Redaction Process

A number of petitioners raise a variety of objections to the redaction process in a further attempt to discredit the Switching Cost Information System (SCIS) disclosure process.¹ At the outset, the redaction effort was prescribed to both preserve the confidentiality of the Bellcore model and the vendor data contained therein, while allowing participants in the ONA tariff proceedings appropriate access to the cost data. There are two essential questions regarding the effectiveness of the redaction effort. First, were the redactions warranted. Second, did the redactions prevent petitioners from constructively contributing to the review process.

The redactions eliminated two classes of information. First and foremost, it eliminated all information that the switch vendors determined could disadvantage their position vis-a-vis their competitors. It is important to note here that Ameritech did not participate in, or have forehand knowledge of redaction specifics. The switch vendors made the determination that certain information would either disclose pricing (or discount) specifics, or switch architecture information that could be used - directly or indirectly - by customers, or potential customers, or competitors to the vendor's detriment.

For its part, Bellcore simply performed the redactions at the direction of the switch vendors. This was appropriate inasmuch as, Bellcore obtains vendor proprietary information under strict terms and conditions set forth in Nondisclosure Agreements. It, therefore, has a legal obligation to the vendors. As for the latter, the vendors have no logical reason to obstruct petitioner review of the ONA tariffs. Indeed, their motivation is solely driven by the need to protect highly competitive and sensitive information that is essential to maintaining a competitive switch manufacturing market. Thus, assertions that SCIS was heavily censored, and the attendant implication that this "censoring" was contrived is contrary to the facts.² The facts are that protecting competition in the switching market is considered more important than providing data which would merely substantiate the conclusions reached by Arthur Andersen, or would prove inconsequential in any determination of the reasonableness of the filed rates.³

¹ Ad Hoc, pp. 4-7; see also Metromedia pp. 9-13; Sprint pp. 4-7; Allnet pp. 8-9; Wiltel pp. 18-20 and MCI pp. 32-34.

² Indeed, Redaction II confirmation letters attached hereto demonstrate that the Redaction II process was performed in conformance with instructions provided to Bellcore by AT&T and NTI.

³ A number of petitioners purchase switches from the very vendors whose data was withheld. Petitioners who have cited the need for access to capacity data (see Ad Hoc p. 6), cost primitives (Metromedia p. 10) and discount data (Metromedia pp. 11-12) would be able to competitively evaluate the merits of switches purchased vis-a-vis those offered by competing vendors. Also, they would be

Secondly, the redaction process eliminated the algorithms used in the modeling process, that represent the intellectual property of Bellcore. It is well established that Bellcore licenses the use of the SCIS program and receives substantial fees in return. Licensees of the SCIS model are not given access to the switch cost information on which SCIS is based, nor to the source code. Moreover, Bellcore requires its licensees to restrict access to the licensed information. These precautions are necessary in light of the ever expanding market for a highly sophisticated cost model.

The redaction process did not prevent a meaningful review of the SCIS or the ONA rate development process as some petitioners claim. Petitioners received SCIS documentation and had access to the software which enabled them to perform sensitivity analyses on most of the relevant inputs including all of those provided by Ameritech. Further, the Arthur Andersen Report and Appendices, when coupled with the redaction process, provided petitioners with sufficient sensitivity results to reach a multiplicity of specific conclusions about the reasonableness of the cost and rate development process. Such definitive conclusions would not have been possible, if the SCIS disclosure process were flawed, and meaningful analysis by petitioners impossible.

Regarding the SCIS model itself, Arthur Andersen reported on its exhaustive review of the model and the economic approaches contained therein, and the Bellcore testing procedures, documentation and user training. In reaching its conclusion regarding the reasonableness of the model, Arthur Andersen did not equivocate. It stated clearly and precisely that the model is "fundamentally sound and provides reasonable estimates of switching system investment." Contrary to the assertions of some petitioners, Arthur Andersen did analyze the engineering related aspects of the model including a comparison of model office results derived from SCIS with results obtained from a switch vendors mechanized pricing tool. Petitioners' contentions that the Andersen report is flawed as it did not explain the principles governing the conduct of a long run incremental cost study, or the impact that prices derived from different costing methodologies have on economic efficiency is premised on a misinterpretation of the Commission's directives as to the substance of the review. Quite simply, Arthur Andersen was not required to discuss the principles governing incremental cost studies, or the impact of various cost methods on cost efficiency, or other attributes of the model, the study process, or the reasonableness of the specific procedures or inputs used by various BOCs.

For petitioners to assert, at this stage in the process, that the review was deficient because it omitted certain analyses is logically flawed. Arthur Andersen submitted its Work Plan on the public record back on March 5. Moreover, Arthur Andersen conducted a workshop for petitioners on May 13 during which it described the scope

able to compare their costs vis-a-vis those paid by Ameritech. Clearly, information that could result in such analysis cannot be disclosed even under the most stringent nondisclosure agreement.

of work to be performed and the analyses that would be conducted. In addition, petitioners were asked to submit comments on the Arthur Andersen review pursuant to a May 15 letter from the Chief, Tariff Division. The comments submitted by all petitioners were included in the final Arthur Andersen Report filed on July 20, along with the actions taken. Such action included revising the scope and substance of the review to accommodate those comments considered both reasonable and within the scope of the review as set forth by the Commission.

CERTIFICATE OF SERVICE

I, Jenell Thompson, do hereby certify that copies of the foregoing Reply Comments of the Ameritech Operating Companies have been mailed this 13th day of November, 1992, by first-class mail, postage prepaid, to the parties on the attached service list.

By: Jenell Thompson
Jenell Thompson

James S. Blaszak
Charles C. Hunter
Gardner, Carton & Douglas
Attorneys for Ad Hoc
Telecommunications Users
Suite 900 - East Tower
1301 K Street, N.W.
Washington, DC 20005

Richard E. Wiley
Robert J. Butler
Wiley, Rein & Fielding
Attorneys for Competitive
Telecommunications Assn.
1776 K Street, N.W.
Washington, DC 20006

J. Scott Nicholls
Roy L. Morris
Allnet Communications
Services, Inc.
1990 M Street, N.W., Suite 500
Washington, DC 20554

Daryl L. Avery
Peter Wolfe
The Public Service Commission
of the District of Columbia
450 Fifth Street, N.W.
Washington, DC 20001

Richard E. Wiley
Michael Yourshaw
William B. Baker
Attorneys for the American
Newspaper Publishers Assn.
Wiley, Rein & Fielding
1776 K Street, N.W.
Washington, DC 20006

L. Michelle Boeckman
Ericsson Network Systems, Inc.
730 International Parkway
Richardson, TX 75081

Michael J. Ettner
General Services Administration
Room 4002
18th & F Streets, N.W.
Washington, D.C. 20405

Larry A. Blosser
Frank W. Krogh
Donald J. Elando
MCI Telecommunications
Corporation
1801 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Michael D. Lowe
Lawrence W. Katz
Bell Atlantic Telephone Companies
1710 H Street, N.W.
Washington, DC 20006

Randall B. Lowe
John E. Hoover
Michael R. Carper
Jones, Day, Reavis & Pogue
Attorneys for Metromedia Comm. Corp.
1450 G Street, N.W.
Washington, DC 20005

James F. Britt
Bell Communications Research
LCC 2E-243
290 W. Mt. Pleasant Ave.
Livingston, NJ 07039

William B. Barfield
Richard M. Sbaratta
Rebecca M. Lough
BellSouth Telecommunications, Inc.
1155 Peachtree St., N.E., Suite 1800
Atlanta, GA 30367-6000

Lawrence E. Sarjeant
James T. Hannon
U S West Communications, Inc.
Suite 700
1020 19th Street, N.W.
Washington, DC 20036

Albert M. Halprin
Stephen Goodman
Martin Mendelsohn
Halprin, Mendelsohn & Goodman
Attorneys for Northern Telecom, Inc.
Suite 1020 East Tower
1301 K Street, N.W.
Washington, DC 20005

Patrick A. Lee
Deborah Haraldson
NYNEX
120 Bloomingdale Road
White Plains, NY 10605

Leon M. Kestenbaum
US Sprint Communications
Company Limited Partnership
1850 M St., N.W., Suite 1110
Washington, DC 20036

Jo Ann Goddard Riley
Nevada Bell/Pacific Bell
Suite 400
1275 Pennsylvania Ave., N.W.
Washington, DC 20004

Durward D. Dupre
Richard C. Hartgrove
Thomas A. Pajda
Southwestern Bell Telephone Co.
1010 Pine St., Room 2114
St. Louis, MO 63101

Peter A. Rohrback
Karis A. Hastings
Hogan & Hartson
Attorneys for Williams
Telecommunications Group, Inc.
555 13th St., N.W.
Washington, DC 20004

Francine J. Berry
David P. Condit
Peter H. Jacoby
AT&T
Room 3244J1
295 N. Maple Ave.
Baskingridge, NJ 07920